IN THE HIGH COURT OF GUJARAT AT AHMEDABAD

INCOME TAX REFERENCE No 23 of 1987

For Approval and Signature:

Hon'ble MR.JUSTICE M.S.SHAH
and
Hon'ble MR.JUSTICE D.A.MEHTA

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1. Whether Reporters of Local Papers may be allowed to see the judgements? : NO

2. To be referred to the Reporter or not? : NO

3. Whether Their Lordships wish to see the fair copy of the judgement? : NO

4. Whether this case involves a substantial question of law as to the interpretation of the Constitution of India, 1950 of any Order made thereunder? : NO

5. Whether it is to be circulated to the Civil Judge? : NO

SCIENTIFIC MACHINE WORKS

Versus

COMMISSIONER OF INCOME TAX

Appearance:

1. INCOME TAX REFERENCE No. 23 of 1987
MR RK PATEL for Petitioner No. 1
MR AKIL KURESHI with MR MANISH R BHATT for Respondent No. 1

CORAM : MR.JUSTICE M.S.SHAH
and
MR.JUSTICE D.A.MEHTA

Date of decision: 10/10/2001

ORAL JUDGEMENT

(Per : MR.JUSTICE D.A.MEHTA)

The Income-tax Appellate Tribunal, Ahmedabad

Bench "A" has referred the following two questions for the opinion of this Court under Section 256(1) of the Income-tax Act, 1961 (hereinafter referred to as "the Act") at the instance of the assessee :-

"1. Whether on the facts and in the circumstances of the case, the Tribunal was right in law in holding that the case of the assessee was covered by provisions of Section 187 of the I.T. Act, 1961 and therefore, provisions of Section 188 of the Act would not apply ?

2. Whether on the facts and in the circumstances of the case, the Tribunal was justified in law in not considering that the case of the assessee was only with regard to cost to the assessee as contemplated u/s. 43 of the Act and not with regard to either Section 187 or Section 188 of the Act ?

2. The assessee-applicant is a partnership firm. The assessment year is 1984-85 and the relevant accounting period is S.Y. 2039, commencing on 16.11.1982 and ended on 4.11.1983. The partnership constituted by ten partners was in existence since 25.10.1978. It appears from the record that seven partners out of the ten partners were desirous of retiring from the firm and hence, on 1.11.1982 a deed was executed amongst the ten partners comprising of the seven outgoing partners on the one hand and the three remaining partners on the other hand. The three remaining partners entered into a new partnership with seven different persons on 16.11.1982. The firm's name in case of the old partnership as well as the new partnership remained the same viz. Scientific Machine Works, Surendranagar.

3. At the time when the seven outgoing partners settled their accounts as on 30.10.1982, the assets of the firm were got revalued by a registered approved valuer and the total figure of such revaluation came to Rs.20,50,782/-. Out of this, Rs.9,23,170/- pertained to the enhanced value placed on the machinery which was already held by the firm. This enhanced valuation was debited to the machinery account and in the proportion of shares held by all the ten partners of the erstwhile partnership, respective sums were credited to the capital accounts of the new partners. It is on the basis of this revaluation, that the outgoing partners were actually paid the sums that they were entitled as being the value

of their respective capital in the partnership firm.

4. The assessee-firm claimed depreciation on the enhanced figure for the assessment year under consideration, but the Income-tax Officer held that depreciation could be allowed only on the written down value as at the end of the year S.Y. 2038 because there was merely a change in the constitution of the firm and in light of the provisions of Section 187(2) of the Act, the business of the firm continued to be carried on by the new sets of partners. It was further held by the Income-tax Officer that in fact no new firm had come into existence and it was only a reconstituted firm. The assessee succeeded in its appeal before the Commissioner of Income-tax (Appeals) and the revenue went in appeal before the Tribunal.

5. On behalf of the revenue, it was submitted before the Tribunal that the Commissioner of Income-tax (Appeals) was in error in holding that it was a case of succession of one firm by another under Section 188 of the Act. It was further contended that there was no dissolution as held by the Commissioner of Income-tax (Appeals) but only a change in the constitution of the firm. On behalf of the assessee, it was submitted that the case of the assessee was not with regard to applicability or otherwise of Section 187 or 188 of the Act, but the assessee based its claim upon the provisions of Section 43(1) of the Act, which define "actual cost". It was, therefore, contended on behalf of the assessee that even if it was assumed for the sake of argument that there was a change in the constitution of the firm, a new association of persons had come into existence in place of the original association of persons and, therefore, the actual cost, by way of capital brought in by the incoming partners, had to be taken into consideration for the purposes of working out the figure on which depreciation had to be worked out. The Tribunal for the reasons stated in its order held that the provisions of Section 187 of the Act were applicable to the facts of the case and the Commissioner of Income-tax (Appeals) fell into error by holding that this was a case of dissolution under Section 188 of the Act. The Tribunal also held that the assessee's case was governed by the provisions of Section 43(6)(b) of the Act and as the assessee remained the same, depreciation had to be allowed only on the written down value.

6. When this reference came up for hearing on 3.8.2001 before the bench comprised of Justice A.R. Dave and Justice D.A. Mehta, after hearing the parties for

some length of time, it was felt that it would be necessary to look into the partnership deeds as well as the retirement deed which had been taken into consideration by the Tribunal and hence, the Tribunal was directed vide order dated 3.8.2001 to forward the entire paper book which was submitted before the Tribunal by way of a supplementary statement of case. Accordingly, supplementary statement of case comprising of entire paper book (54 pages) has been submitted by the Tribunal. It appears that the Registry of this Court has assigned a separate number being Income-tax Reference No. 24 of 2001 to the supplementary statement of case instead of treating the supplementary statement of case as part of the original reference. Therefore, Income-tax Reference No. 24 of 2001 shall also be treated as being disposed of by this judgment.

7. Mr RK Patel, learned advocate appearing on behalf of the assessee-applicant contended that the Tribunal had fallen into error in considering the case of the assessee as being governed by the provisions of Section 187 of the Act. In fact, it was submitted that the assessee had contended only to the effect that regardless of provisions of Section 187 or 188 of the Act, the claim of the assessee was governed by the provisions of Section 43(1) of the Act and what was necessary for the Tribunal to take into consideration was, what was the actual cost to the assessee firm. It was submitted that Section 32 of the Act provided for depreciation allowance on the actual cost in relation to the assets used for the purposes of business. In the alternative, it was submitted that on facts Section 187 of the Act was not applicable taking into consideration various clauses of the retirement-cum-dissolution deed. That the accounts of all the ten partners had been settled as could be seen from the entries made in the account books and hence it was a case of dissolution and not retirement. It was further submitted that Explanation 3 to Section 43 of the Act had not been invoked by the Income-tax Officer and hence it was the case of a bona fide transaction and the assessee was accordingly entitled to depreciation on the enhanced value of the assets.

8. On the other hand, Mr Akil Kureshi appearing on behalf of the revenue stated that as the three partners from the erstwhile partnership firm continued in the new partnership, it presupposes the existence of the partnership allthroughout and was not a case of dissolution. Referring to various clauses of the deed dated 1.11.1982, it was submitted that on an over all reading it could be gathered that it was a deed of

retirement and not a deed of dissolution. Accordingly, it was submitted that the Tribunal was justified in holding that it was a case of change of constitution of the partnership and if that was so, the Tribunal's order did not call for any interference or modification.

9. We have gone through the relevant documents especially the deed executed on 1.11.1982 and prima facie we are of the opinion that the same is a deed of retirement and not a deed of dissolution. However, examining the matter from both the aspects, namely that of retirement and/or dissolution, in light of the settled legal position it is not necessary to decide the controversy as to whether there was a change in the constitution of the firm or it was a case of succession of one firm by another firm.

10. When this Court was called upon to decide as to whether on retirement of a partner from the firm, the assessee-partner was liable to capital gains and whether the interest in partnership asset was a capital asset which could be said to have been transferred by the retiring partner, in the case of CIT vs. Mohanbhai Pamabhai, (1973) 91 ITR 393, it was held by this Court in the following terms :-

> The interest of a partner in a partnership is not interest in any specific item of the partnership property. It is a right to obtain his share of profits from time to time during the subsistence of the partnership and on dissolution of the partnership or on his retirement from the partnership to get the value of his share in the net partnership assets which remain after satisfying the debts and liabilities of the partnership. When, therefore, a partner retires from a partnership and the amount of his share in the net partnership assets after deduction of liabilities and prior charges is determined on taking accounts on the footing of notional sale of the partnership assets and given to him, what he receives is his share in the partnership and not any consideration for transfer of his interest in the partnership to the continuing partners. His share in the partnership is worked out by taking accounts in the manner prescribed by the relevant provisions of the partnership law and it is this, namely, his share in the partnership which he receives in terms of money. There is in this transaction no element of transfer of interest in the partnership assets by

the retiring partner to the continuing partners."

After laying down the nature of interest of a partner in a partnership firm, the Court opined in relation to transfer in the following terms :-

"Section 2(47) defines "transfer" in relation to a capital asset. This definition gives an artificially extended meaning to the term by including within its scope and ambit two kinds of transactions which would not ordinarily constitute "transfer" in the accepted connotation of that word, namely, relinquishment of the capital asset and extinguishment of any rights in it. But, even in this artificially extended sense, there is no transfer of interest in the partnership assets involved when a partner retires from the partnership."

This decision came to be affirmed in the case of Additional CIT vs. Mohanbhai Pamabhai, (1987) 165 ITR 166.

11. This was the situation in the event of retirement of a partner from the partnership firm. In relation to dissolution of a firm, the Apex Court in the case of Malabar Fisheries Co. vs. CIT, (1979) 120 ITR 49, while dealing with a case of withdrawal of development rebate laid down as follows :-

"A partnership firm under the Indian Partnership Act, 1932, is not a distinct legal entity apart from the partners constituting it and equally in law the firm as such has no sperate rights of its own in the partnership assets and when one talks of the firm's property or the firm's assets all that is meant is property or assets in which all partners have a joint or common interest. It cannot, therefore, be said that, upon dissolution, the firm's rights in the partnership assets are extinguished. It is the partners who own jointly or in common the assets of the partnership and, therefore, the consequence of the distribution, division or allotment of assets to the partners which flows upon dissolution after discharge of liabilities is nothing but a mutual adjustment of rights between partners and there is no question of any extinguishment of the

firm's rights in the partnership assets amounting to a transfer of assets within the meaning of S.2(47) of the I.T. Act, 1961. There is no transfer of assets involved even in the sense of any extinguishment of the firm's rights in the partnership assets when distribution takes place upon dissolution.

In order to attract S. 34(3)(b) it is necessary that the sale or transfer of assets must be by the assessee to a person. Dissolution of a firm must, in point of time, be anterior to the actual distribution, division or allotment of the assets that takes place after making accounts and discharging the debts and liabilities due by the firm. Upon dissolution the firm ceases to exist : then follows the making up of accounts, then the discharge of debts and liabilities and thereupon distribution, division or allotment of assets takes place inter se between the erstwhile partners by way of mutual adjustment of rights between them. The distribution, division or allotment of assets to the erstwhile partners, is not done by the dissolved firm. In this sense there is no transfer of assets by the assessee (dissolved firm) to any person. It is not correct to say that the distribution of assets takes places eo instanti with the dissolution of the firm or that it is effected by the dissolved firm."

12. Once again in the context of the applicability of provisions of Gift Tax Act at the time of retirement of a partner from the partnership firm, the issue came up before the Apex Court in the case of Commissioner of Gift Tax vs. T.M. Louiz, (2000) 245 ITR 831 and the earlier ratio was reiterated in the following terms :-

"When a partner retires from a partnership, the partnership continues. The assets and the goodwill of the firm continue to remain the assets and the goodwill of the firm. All that the retiring partner gets is the value of his share in the partnership assets less its liabilities."

13. Having seen the legal position in relation to both the situations, namely retirement as well as dissolution, we may examine the provisions of Explanation 3 to Section 43(1) of the Act, which reads as under :-

"Explanation 3 : Where, before the date of acquisition by the assessee, the assets were at any time used by any other person for the purposes of his business or profession and the Income-tax Officer is satisfied that the main purpose of the transfer of such assets, directly or indirectly to the assessee, was the reduction of a liability to income-tax (by claiming depreciation with reference to an enhanced cost), the actual cost to the assessee shall be such an amount as the Income-tax Officer may, with the previous approval of the Inspecting Assistant Commission, determine having regard to all the circumstances of the case."

The provision requires that in case assets were used by any other person before the date of acquisition by the assessee and the main purpose of transfer of such assets is to reduce tax liability by claiming depreciation with reference to enhanced cost, the actual cost to the assessee shall be the amount as the Income-tax Officer may determine having regard to all the circumstances of the case. In the present case, as can be seen, there is no question of the assets being used by any other person before the date of acquisition by the assessee, because at the point of time of retirement or dissolution, the firm remained as such, i.e. the assessee, continues to be the assessee and there is no transfer of assets by any other person. In other words, the assets which were used by the firm for the purposes of its business continued to remain with the firm and, therefore, the said Explanation 3 to Section 43(1) cannot come into play. The resultant effect is that the actual cost to the assessee remains the same i.e. at the written down value because the assessee does not acquire any asset during the previous year, which is the fundamental requirement for stating that the actual cost to the assessee for the assets acquired is the cost which is actually incurred by the assessee. All that has happened is that the partners have settled their accounts inter se without there being any transfer of assets from one entity to another.

14. In view of the aforesaid situation, we hold that the Tribunal was right in law in holding that the assessee was not entitled to depreciation on the enhanced value of the assets. In light of this, the second question referred to us requires to be reframed in the following manner :-

"Whether on the facts and in the circumstances of the case, the Tribunal was justified in law in holding that the assessee was not entitled to the actual cost as contemplated under the provisions of Section 43(1) of the Act and that the assessee would be governed by the provisions of Section 43(6)(b) of the Act ?"

The second question as reframed is, therefore, answered in the affirmative i.e. in favour of the revenue and against the assessee. In light of our answer to question No. 2, it is not necessary to render any opinion in relation to question No. 1.

The reference is disposed of accordingly with no order as to costs.

(M.S. Shah, J.)

(D.A. Mehta, J.)

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